

Committee to Study Washington State's Tax Structure (ESSB 6153, Section 138)

“... to determine how well the current tax system functions and how it might be changed to better serve the citizens of the state in the 21st Century.”

Due November 30, 2002

Committee Appointments

Governor appointment

- William Gates, Sr.

Caucus appointments

- Sen. Lisa Brown
- Gary Strannigan
- Rep. Jim McIntire
- Rep. Jack Cairnes

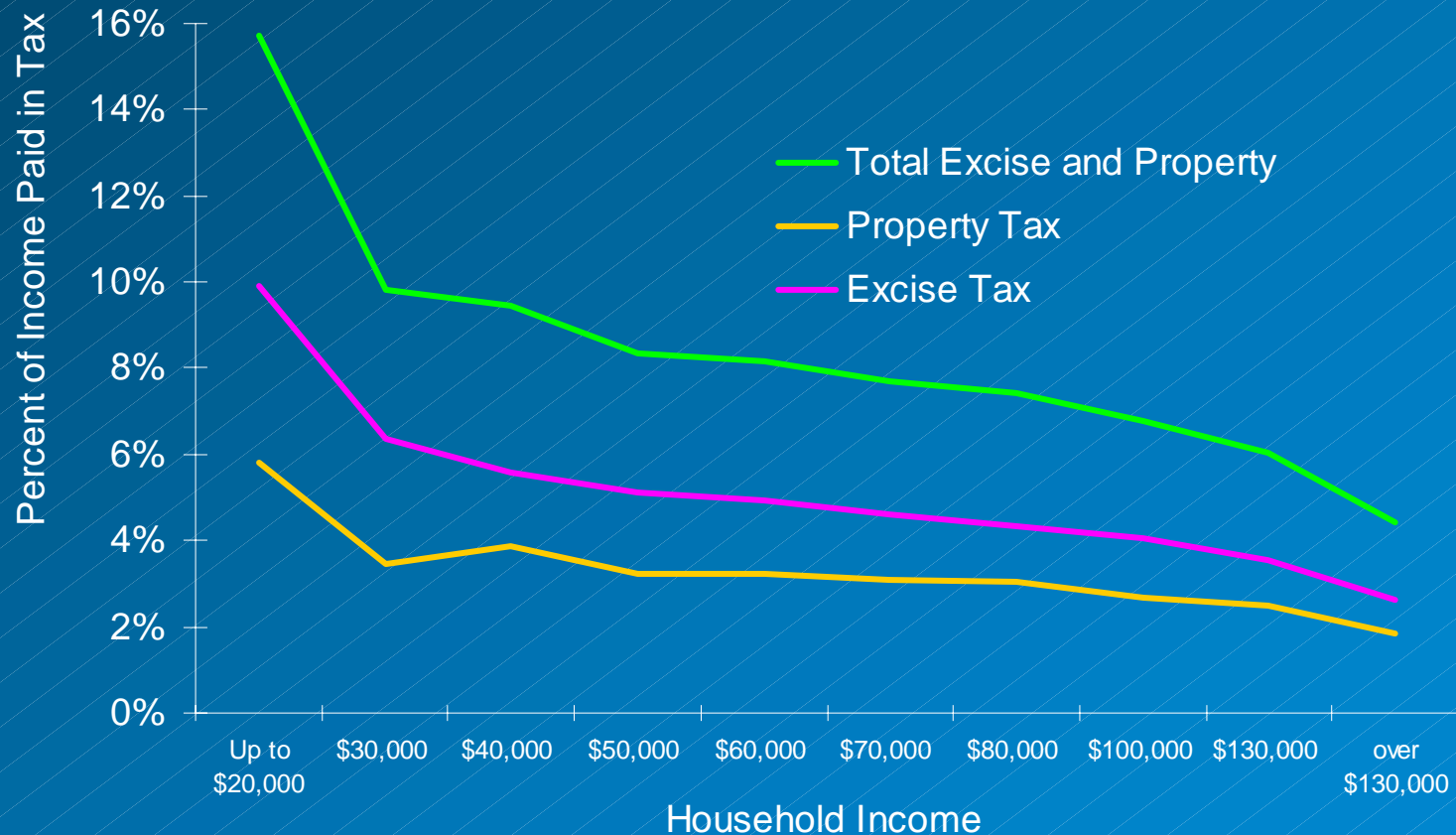
Academic appointments

- John Beck
Gonzaga University School of Business Administration
- Neil Bruce
University of Washington Economics Department
- Dick Conway
Consultant, Governor's Council of Economic Advisors
- Lily Kahng
Seattle University School of Law
- Debra Sanders
Washington State University School of Accounting
- Hugh Spitzer
Attorney, University of Washington

Problems with our current tax structure

Regressivity

- Lower income households pay a higher percentage of their income in state and local taxes than do higher income households.



Problems with our current tax structure

Exportability

- State and local taxes are more burdensome because the retail sales tax paid by households is not deductible from federal income taxes.

Illustration

STATE RST REPLACED BY 5.5% PERS INCOME TAX

Net Decrease in Business Taxes	-\$1.5 billion
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Net Increase in Household Taxes	
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Sales tax reduction	-\$4.2 billion
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Personal income tax	+\$6.7 billion
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Federal tax reduction	<u>-\$1.5 billion</u>
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	\$1.0 billion
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NET REDUCTION OVERALL	\$0.5 billion
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Problems with our current tax structure

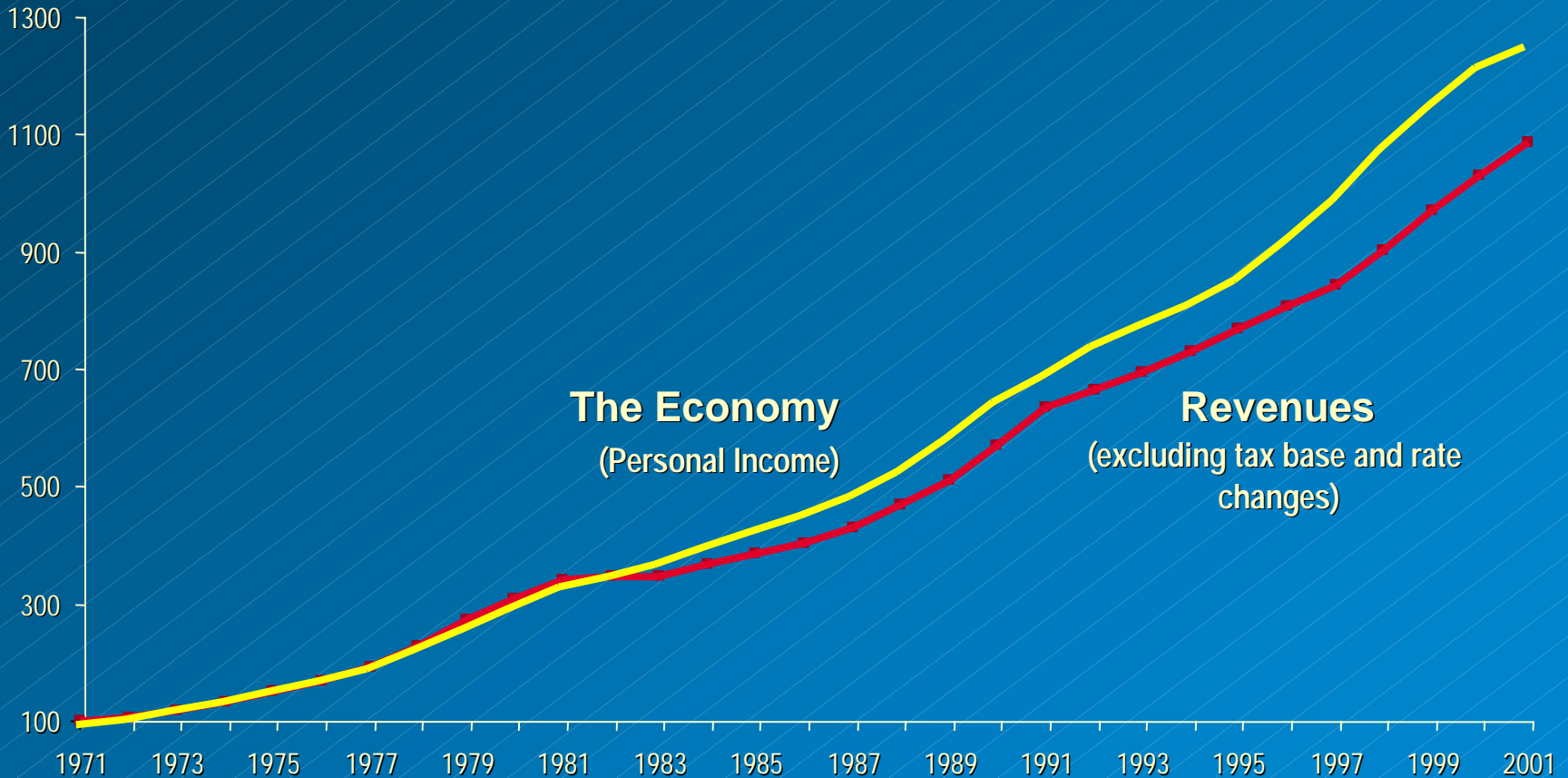
Adequacy

- It is politically difficult to build and maintain adequate reserve funds during good economic times.
- Initiatives have impacted long run adequacy.
- Initiatives and state-imposed reductions in tax bases have impacted local adequacy.

Problems with our current tax structure - Adequacy

Excluding tax base and rate changes, over the past 30 years
General Fund revenues have grown more slowly than the
economy (personal income).

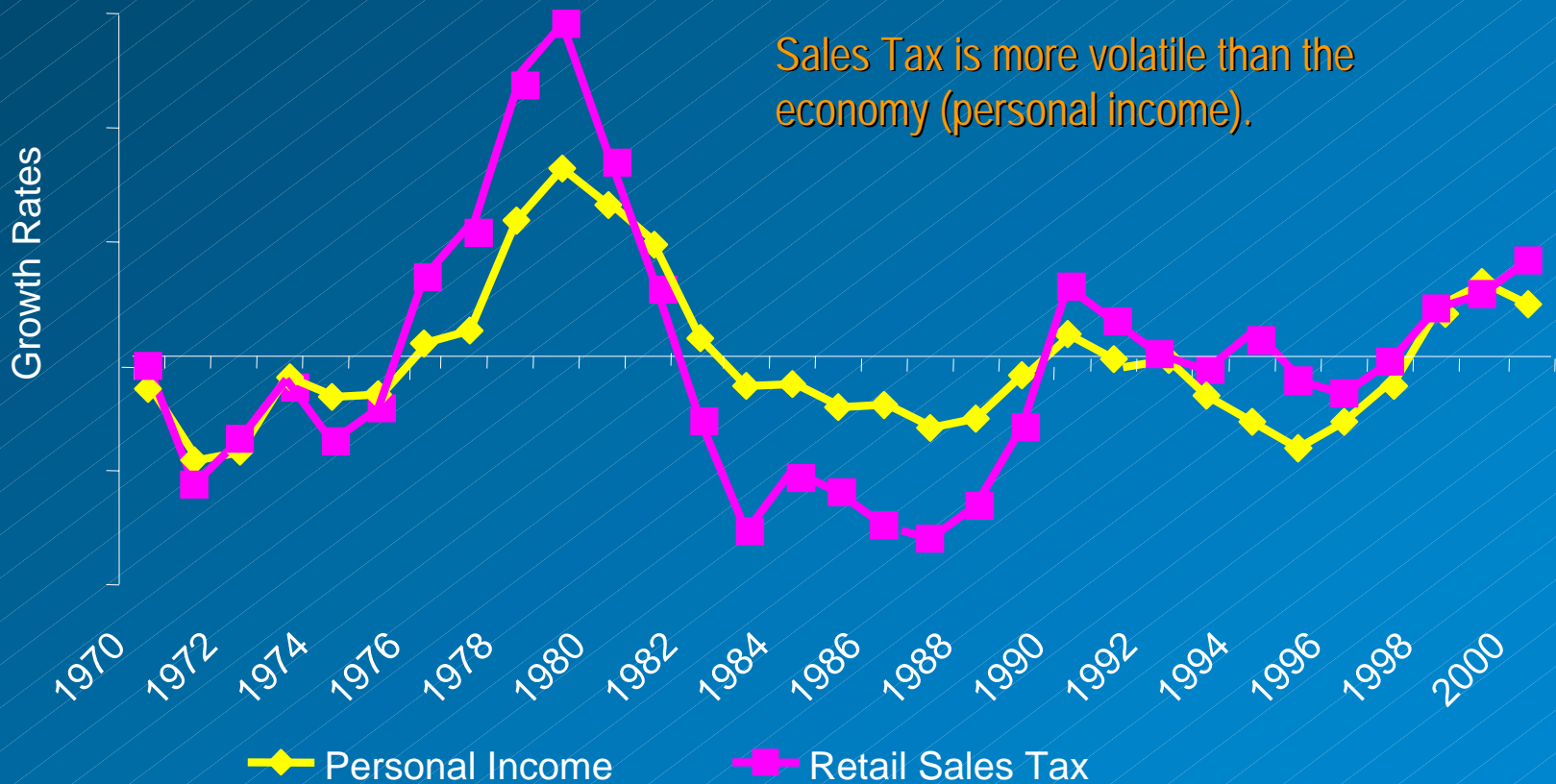
Percent of
1971 value



Problems with our current tax structure

Volatility

Washington's mix of taxes causes revenues to increase more than personal income during good economic times and less than personal income in economic downturns.



Inflation and other trends have been eliminated. Growth rates are due only to volatility.

Problems with our current tax structure

Erosion of the Tax Base

- The increasing share of services in consumer spending, along with increased opportunities for making purchases out of state, result in taxable retail sales growing more slowly than the economy as a whole over the long run.
- Individuals can avoid sales tax by shopping in bordering states with lower sales tax rates or by making remote purchases.

Problems with our current tax structure

B&O taxes are not neutral

- **Some Washington firms are able to avoid the B&O tax by shifting their income generating activities (such as manufacturing) to other states.**
- **B&O tax pyramiding (at least 2:1) results in non-neutralities between different industries and between vertically integrated and non-integrated firms**

Problems with our current tax structure

Business taxes are “hidden”

- To the extent that business taxes are passed on to consumers, business taxes are not transparent.

Menu of Major Alternatives

Problems Addressed

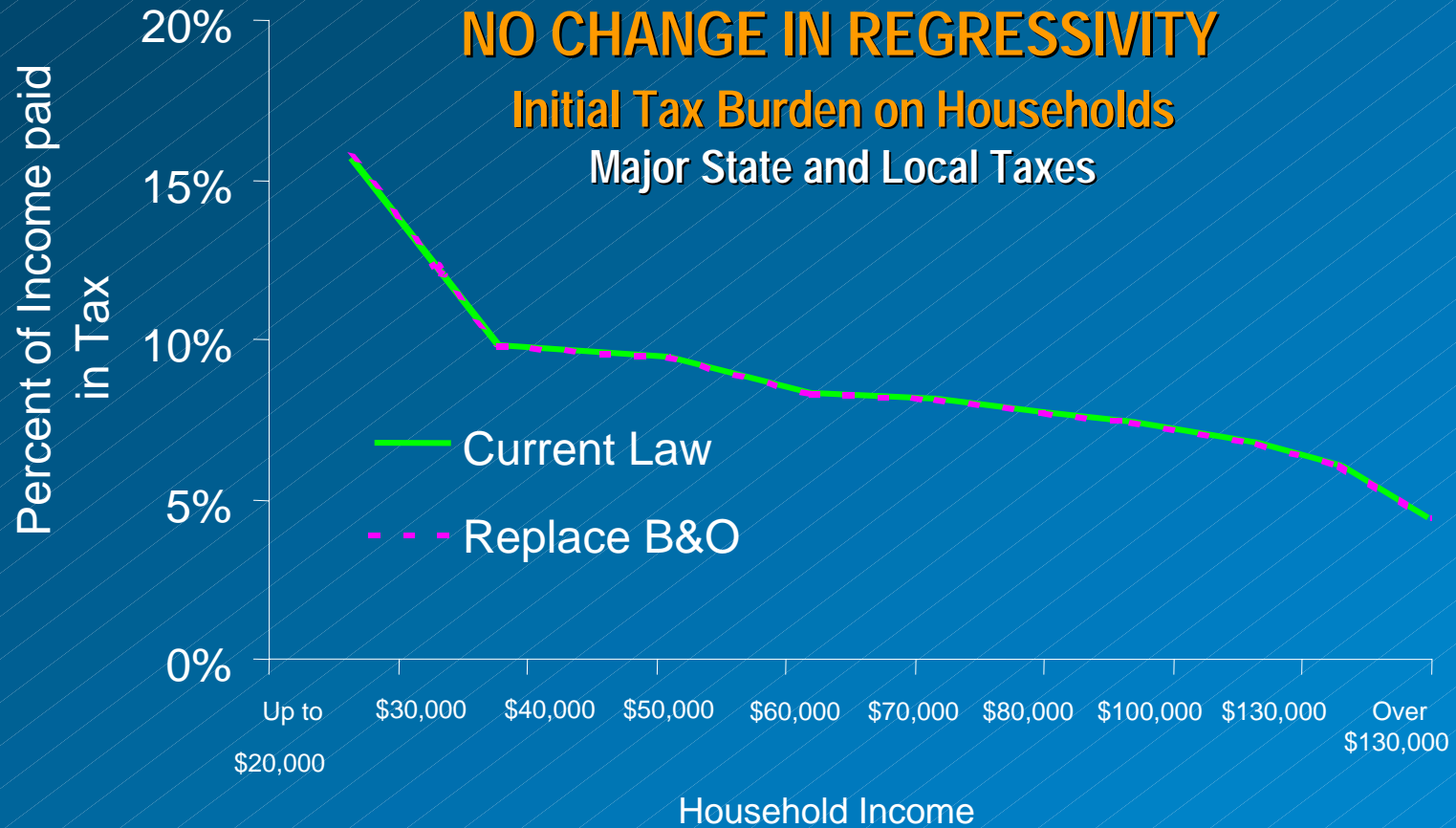
Business Value Added Tax (VAT)	<i>Neutrality</i>
Goods and Services Tax (GST)	<i>Neutrality, Transparency, Erosion</i>
“Progressive” VAT (low-income relief)	<i>Neutrality, Transparency Regressivity</i>
Flat Rate Personal Income Tax	<i>Erosion, Regressivity</i>
Graduated Personal Income Tax	<i>Erosion, Regressivity</i>
Flat Personal and Corporate Income Tax	<i>Erosion, Regressivity</i>

Replacement Alternatives

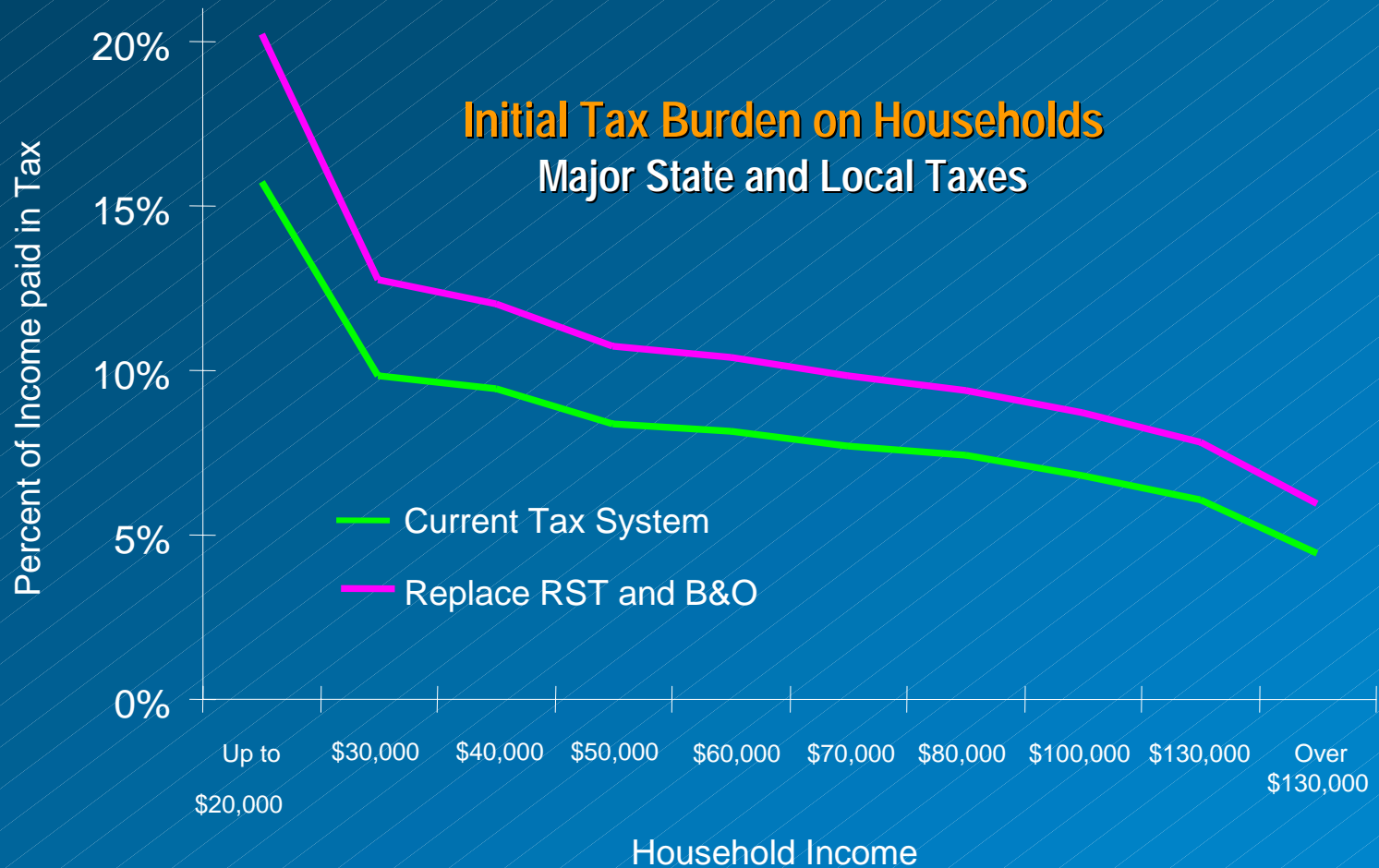
Value Added Tax Alternatives

		Existing Taxes Reduced or Replaced	Revenue Neutral VAT Tax Rate
#1	Business VAT	Replace B&O tax	2.2%
#2	Goods & Services Tax	Replace state sales/use tax and B&O taxes	9.0%
#3	Progressive VAT	Reduce state sales/use tax from 6.5% to 3.5% Replace B&O taxes	3.9%

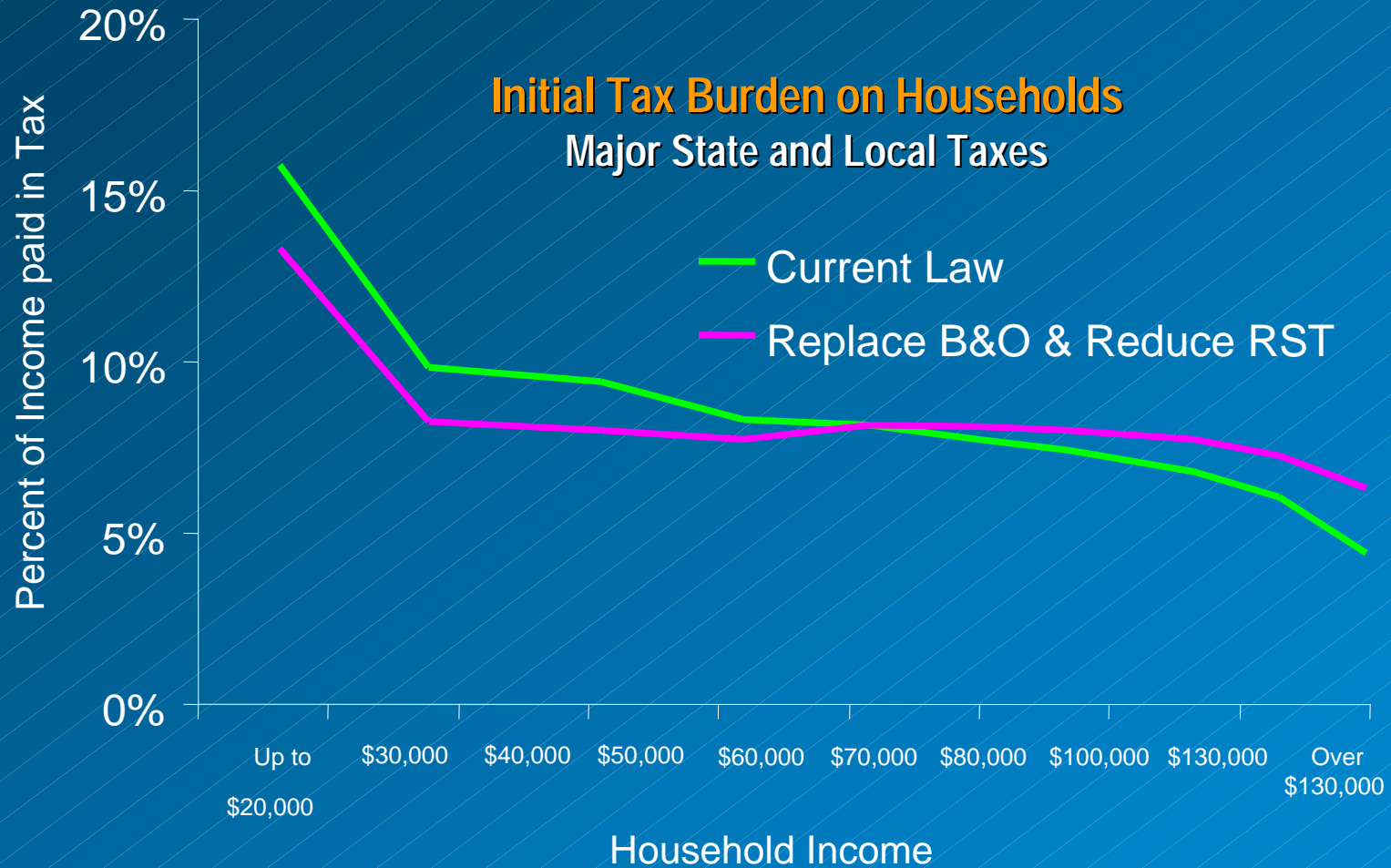
#1 Subtraction Method VAT at 2.2% Replaces B&O



#2 Goods and Services Tax

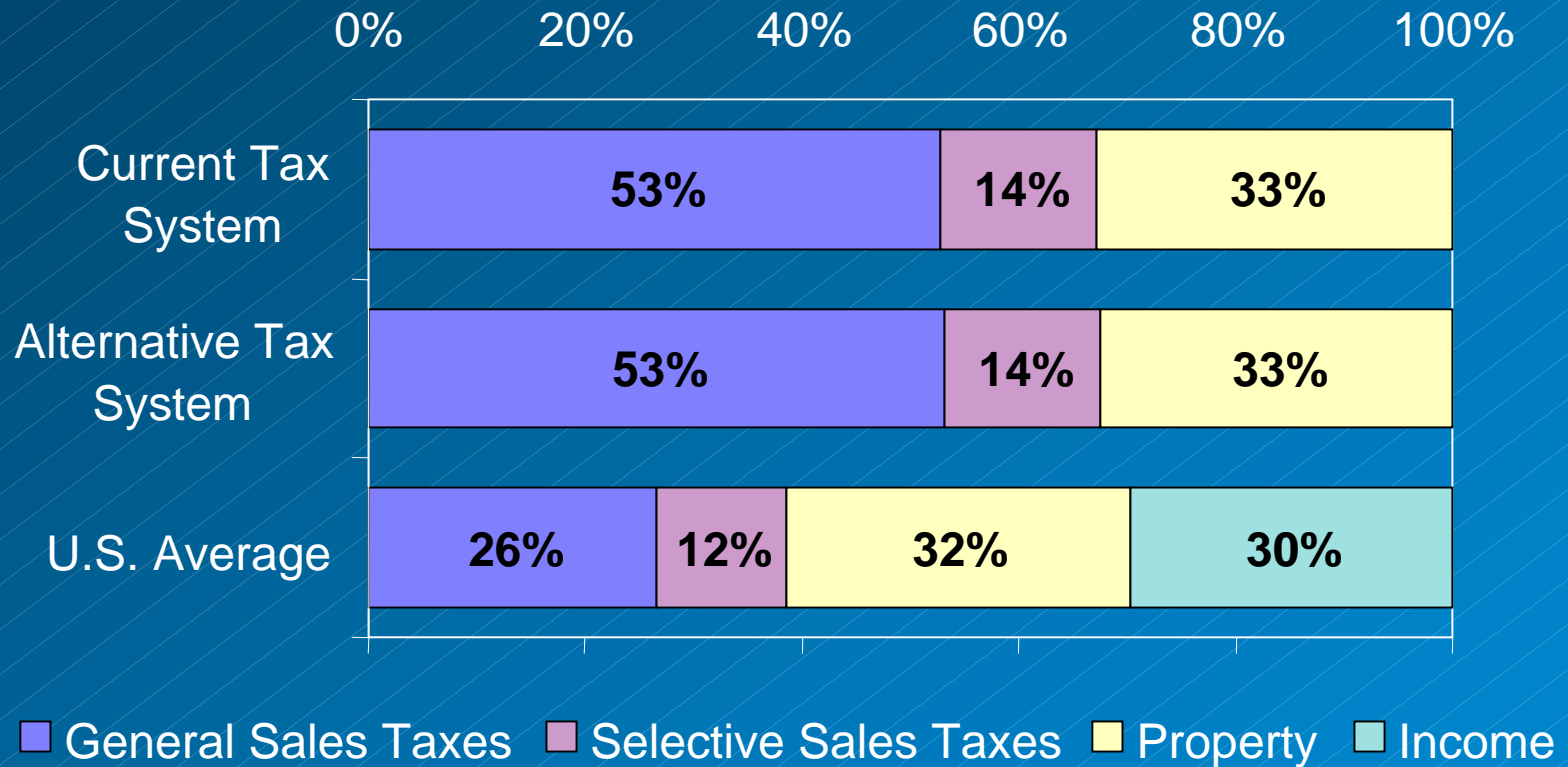


#3 “Progressive” VAT



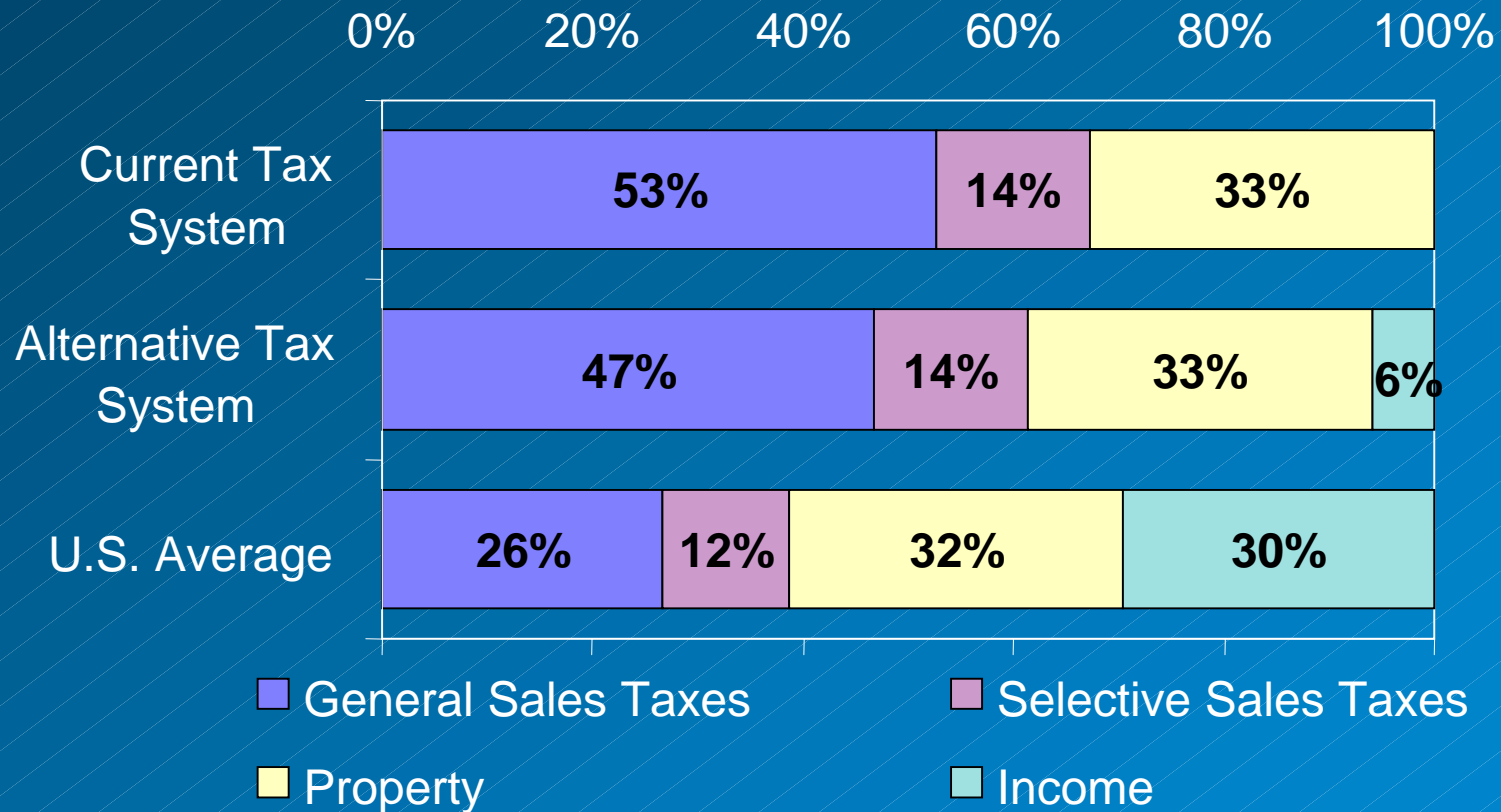
Percent Reliance on Major State and Local Taxes

#2 Goods and Services Tax



Percent Reliance on Major State and Local Taxes

#3 "Progressive" VAT



#4 Flat Rate Personal Income Taxes

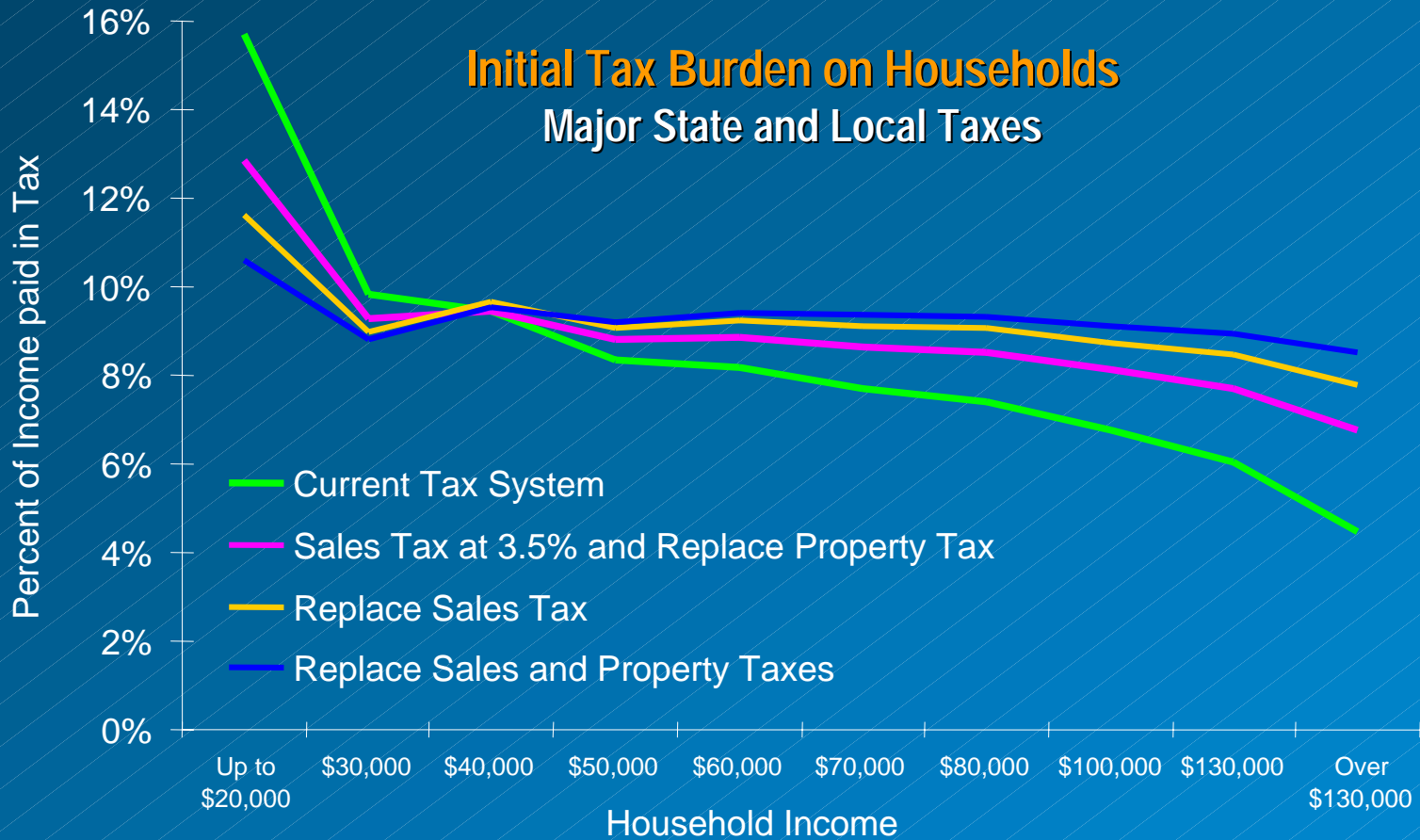
Existing Taxes Reduced or Replaced		Revenue Neutral Income Tax Rate
A	Reduce state sales/use tax from 6.5% to 3.5%	2.6%
B	Reduce state sales/use tax to 3.5% and replace state property tax	3.8%
C	Replace state sales/use tax	5.5%
D	Replace state sales/use tax and state property tax	6.7%

#5 Graduated Personal Income Taxes

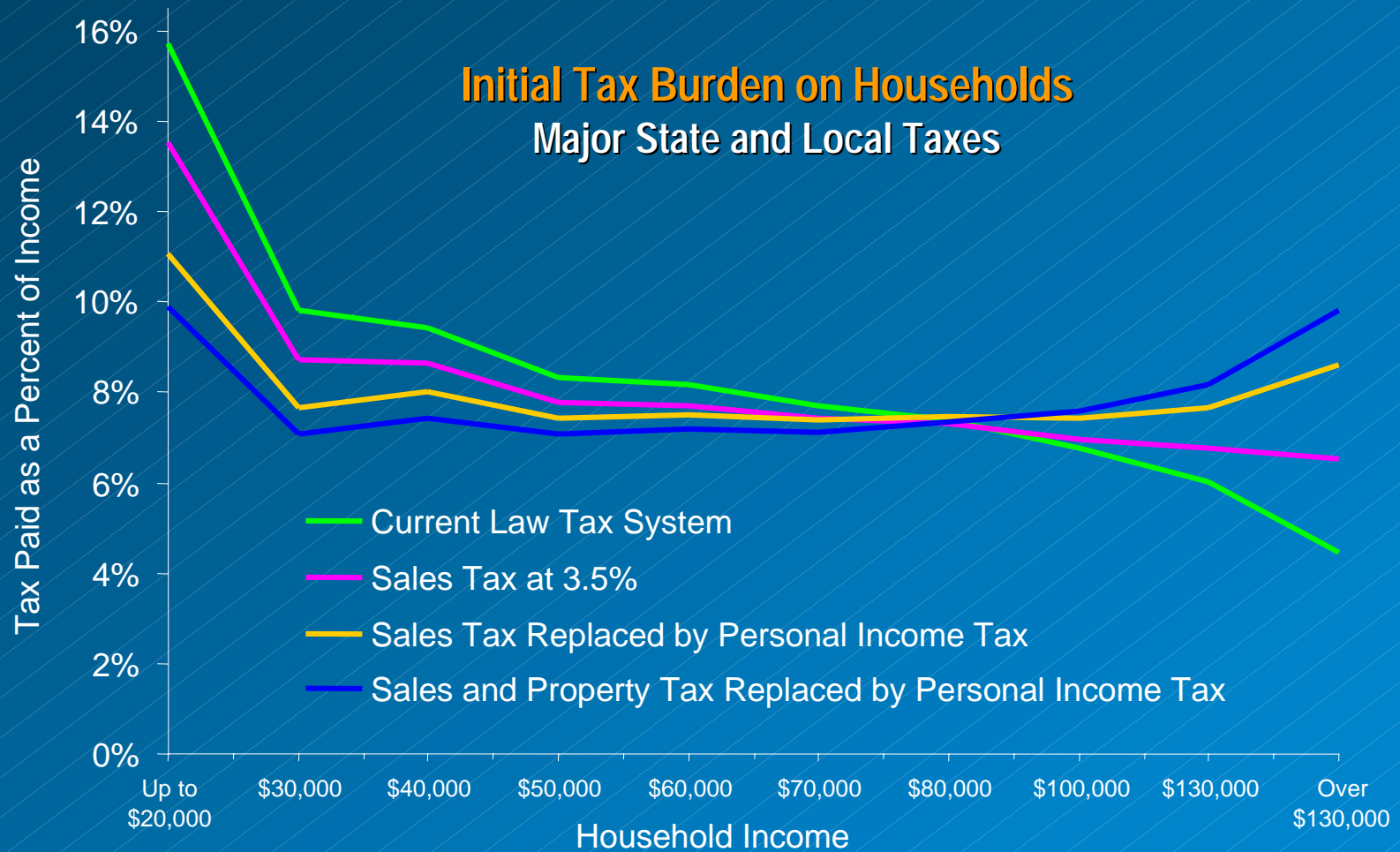
Existing Taxes Reduced or Replaced	Revenue Neutral Rates for Joint Returns		
	\$0 to 49,900	\$49,900 to 120,650	\$120,650 and over
A Reduce state sales/use tax from 6.5% to 3.5%	1.0%	2.7%	4.5%
B Reduce state sales/use tax from 6.5% to 3.5% and replace state property tax	2.2%	3.5%	6.0%
C Eliminate state sales/use tax	2.7%	5.7%	8.7%

Note: The income break points for single filers are \$0 to 24,950, up to \$60,325 and over \$60,325.

#4 Flat Rate Personal Income Taxes

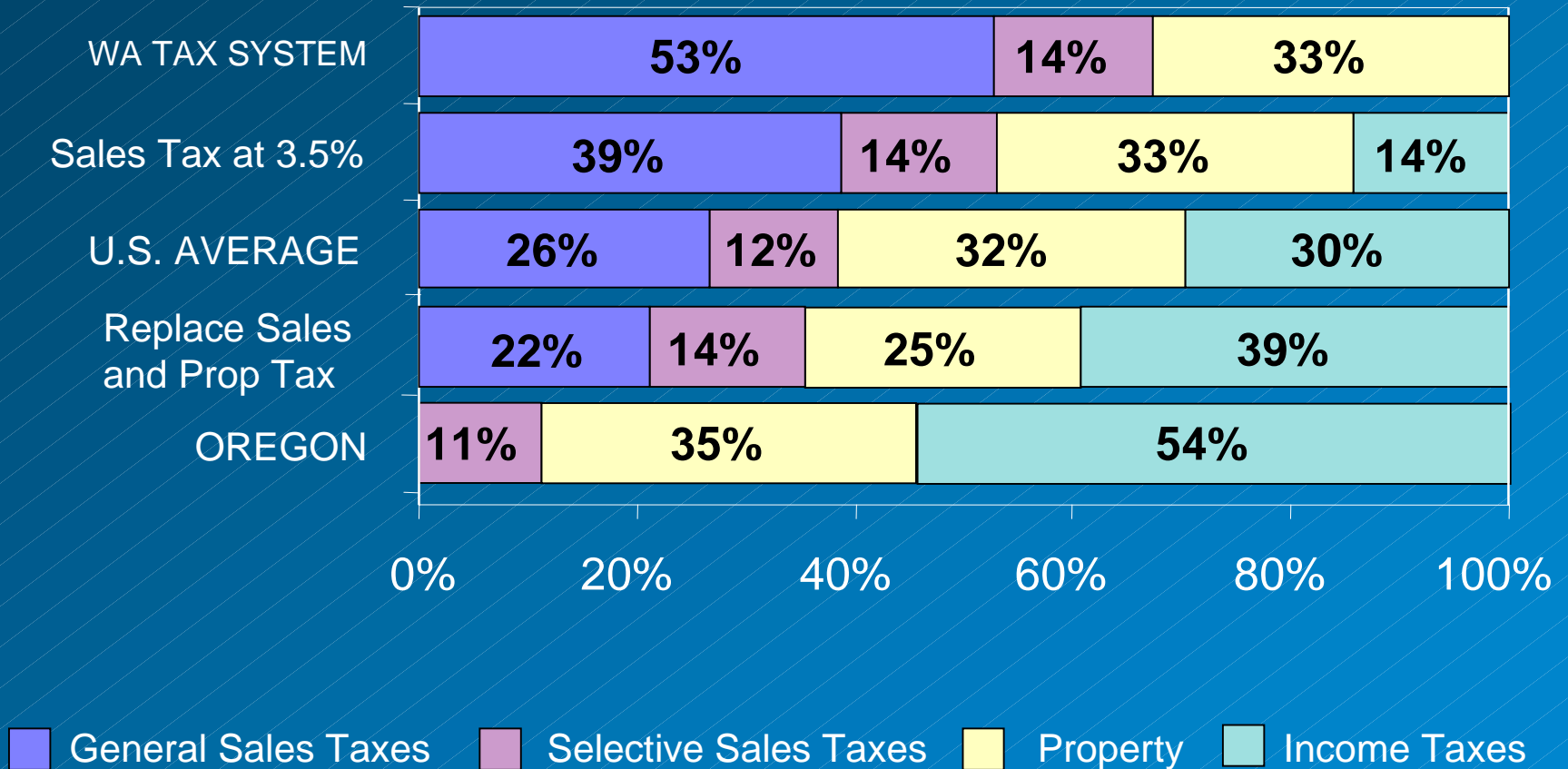


#5 Graduated Rate Personal Income Taxes



Percent Reliance on Major State and Local Taxes

#4 and #5 Flat and Graduated Income Taxes



Long Term Adequacy

Personal Income Tax v. Sales Tax



Improvements to the Current System

Continue to impose an estate tax.

- Tax in the amounts of the state credit allowed under prior federal law.
- Adequacy - Prevents an increase in regressivity by maintaining an existing tax on high-income households.
- Current yield estimated at:

CY 2005

\$100 million

Extend the sales tax to consumer services.

- Adds beauty shops, amusement, recreation and cable TV to definition of retail sale.
- Adequacy - extends the base to a growing area of consumption not subject to tax.
- Equity - resolves inequities in our tax system, e.g., video rentals are taxed and movie tickets are not.
- Estimated revenue gain:

CY 2005

\$229.6 million

Join other states in enacting streamlined sales tax legislation.

- **Multistate effort to create simpler, more uniform system for collection of sales tax.**
- **Erosion of the base, equity - leads to collection of retail sales tax on remote sales.**
- **Neutrality - consumers could no longer avoid tax by shopping on the Internet.**
- **Economic vitality - would improve the competitive position of WA retailers.**
- **Simplicity - uniformity would make sales tax simpler for multi-state retailers.**

Extend the watercraft tax to motor homes and travel trailers.

- Consider raising existing rate from 0.5% rate to 1%.
- Equity - motor homes and travel trailers can be substitutes for vacation homes which are taxed.
- Regressivity - upper income households spend more on motors homes/travel trailers as a percent of income.
- Estimated revenue gain:

1% Rate = \$47.5 million in CY 2005

Create a constitutionally mandated “rainy day” fund.

- **Enact a constitutional amendment mandating a “rainy day” fund.**
- **Volatility - sets aside revenues in years when they exceed income growth.**
- **Adequacy - would help prevent permanent decreases in the tax base during good economic years.**

Exempt construction labor from sales tax.

- Only a few states impose a sales tax on labor portion of construction.
- Exempt labor portion of construction contract.
- Problems addressed:

Economic Vitality	Volatility
Tax Harmony	Regressivity
Simplicity	Homeownership
- Estimated revenue loss:

CY 2005	\$400 million
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Increase the B&O small business credit from \$35 to \$70 a month.

- Increase the small business credit to \$70/month.
- Raise the reporting threshold from \$28,000 to \$56,000 in gross.
- Economic vitality - new and expanding firms have high tax burdens. This improvement would assist new and expanding businesses that start out small.
- Estimated revenue loss:

CY 2005

\$28 million

Other improvements to current system

<i>Problem Addressed</i>	
Simplify local B&O tax	<i>Neutrality, economic vitality</i>
Avoid or reduce dedicated taxes (except user fees)	<i>Simplicity</i>
Periodically review tax incentives to determine if they've outlived their purpose.	<i>Adequacy, economic vitality</i>